

Second Submission

To

Expert Group
To Review The Operation
Of The Securities & Futures Market
Regulatory Structure

December 2002



Hong Kong Exchanges and Clearing Limited

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Introduction

1. In its First Submission, Hong Kong Exchanges and Clearing Limited (“HKEx”) stated that it believes the current regulatory structure for listing matters has generally worked well for the past 13 years, and that transferring the listing function to the Securities and Futures Commission (“SFC”) is not warranted and would be detrimental to HK’s competitiveness as a capital formation centre. HKEx indicated, however, that it is considering ways to improve the operation of the system, and would describe its ideas in this second submission. These are contained in Section I below. Section II contains HKEx’s comments in relation to the statutory framework which (as stated in the First Submission) is where HKEx believes the main defects in the present system lie, in relation particularly to protection of minority shareholders. Section III contains additional comments on HKEx’s business development role.

SECTION I

Analysis of Perceived Problems

2. The main structural and organisational problems which HKEx believes need to be addressed are:

(a) **Perception:** There is still a widespread perception that somehow HKEx's "for profit" status could cause it to set listing criteria, or interpret and enforce the Listing Rules, in too lax a manner. HKEx has repeatedly pointed out why it believes this should not be a genuine concern – on account of the extensive safeguards built into the legislation and the separation of functions embedded in the decision-making process for listing matters, together with the high degree of natural congruence which exists between the public interest and that of HKEx's shareholders. On top of this is the fact that the SFC must approve all Listing Rules and monitors HKEx's administration of them closely. However, the perception that a conflict exists has not been fully dispelled. In particular, the "Chinese Wall" between the Listing Committee and HKEx's main business units is still widely overlooked or misunderstood.

(b) **Role of Listing Committee:** The Report of the Panel of Inquiry on the Penny Stock Incident (the "PIPSI Report") identified a lack of clarity which had developed about the role and expectation of the Listing Committee. This is a genuine issue. The workload of the Listing Committee is enormous and will be even greater when it has to deal with both the GEM and Main Board listing matters. All the Committee's members are part-time unpaid "volunteers", with many

other calls on their time. Yet they carry a heavy delegated executive decision-making responsibility. At the same time, they do not have full control over the “agenda”, because they do not control the resource which serves them – the Listing Division. They thus have responsibility without corresponding power. Some members consider that they are in practice playing a reactive and consultative role, rather than a pro-active and decision-making one. This leads to a lack of clarity about their accountability.

(c) Division of Regulatory Responsibilities: There has also been a blurring of the respective roles of the SFC and HKEx. This has led to a diffusion of accountability. The division of responsibilities as described in the 1988 Securities Review Committee report was clear. The Exchange (via the Listing Committee) is responsible for approving listing applications, monitoring compliance with the Listing Rules and taking disciplinary action in relation to breaches. It is the SFC’s job to investigate and apply statutory sanctions to any breaches of statutory (and SFC code) requirements (and it is the Exchange’s job to draw the attention of the SFC to any such suspected breaches). In relation to the Exchange, the SFC should be a “watchdog”. Its role is to ensure that the Exchange is doing its job properly, by means of regular audits, spot checks, following up complaints, requiring reports, and approving changes to the Listing Rules. The only area of overlap between HKEx and SFC should be in relation to policy-setting. All listing rule changes require SFC approval. This calls for a close and co-operative relationship at the policy level. The penny stock incident revealed a malfunctioning of this relationship.

(d) **SFC Intervention:** In recent years, the SFC has operated in an increasingly “interventionist” manner, seeking to involve itself quite frequently in decision-making on individual cases and to direct the Listing Division from behind the scenes in its day-to-day operations. This has created frustration on both sides, and inhibited the Listing Division in making decisions. Such frustration may have spilled over into the policy area. The way that the relationship should work, in HKEx’s view, is that the Exchange and Listing Committee should carry out their day-to-day functions without being “micro-managed” by the SFC. If the SFC becomes dissatisfied with HKEx’s performance of its duties, it should voice its concern at the top level. This could be at the regular meetings of the High Level Group (comprising Chairman and Executive Director (Corporate Finance) of the SFC; Chairman of the Takeovers Panel; Chairman, Chief Executive and Head of LRRM of HKEx; and Chairmen of the Listing Committees). If the SFC is subsequently not satisfied that corrective action has been taken, it has the “nuclear option” of withdrawing HKEx’s listing responsibilities.

(e) **Streamlined Listing Procedures:** There has been market criticism of HKEx’s procedures for handling listing applications, company announcements, etc. These are felt to be overly focussed on the observance of detailed technical requirements; this, it is felt, has caused undue cost and delay to issuers. Steps have already been taken to address this problem through HKEx’s streamlined procedures announced last July, which will take effect in early 2003. These will place a greater onus on listed company directors and their advisers, including particularly investment banking sponsors, to undertake thorough due diligence and ensure full and accurate

disclosure. It remains important that HKEx's institutional arrangements help to direct the Listing Division's focus towards the most substantive issues.

Proposed Adjustments to Institutional Arrangements

3. HKEx believes that it is possible to address the above real and perceived problems through adjustments to HKEx's institutional arrangements, within the existing "three-tier" framework.
4. **Separate Subsidiary:** The main element in HKEx's proposals is the formation of a subsidiary company of HKEx ("Hong Kong Listing Ltd." or "HKL"), to which the Board of HKEx would formally delegate all HKEx's listing-related responsibilities (both for approving listings and on-going administration of the Rules). HKL's constitution would clearly specify its duties, and make it clear that the quality and efficiency of listing regulation is HKL's "bottom line". HKL's budget would be approved by the HKEx Board. It would probably be a cost rather than profit centre. The SFC would, of course, retain its statutory role of approving the level of listing fees.
5. **Exchange Listing Board:** The board of HKL would be known as the Exchange Listing Board ("ELB"). Members of ELB would be appointed by HKEx, subject to a nomination procedure similar to that of the present Listing Committee. The ELB would consist of non-executive, senior and experienced individuals from the market and might include several of the public interest directors on the Board of HKEx. Investors would be well-represented on the ELB. This Board would be the decision-making body on all listing policy matters.

6. **New Listing Committee:** The ELB may appoint various committees and delegate part of its functions to such committees. The Listing Committee would be retained and would deal with individual listing applications and delisting proposals. Investors would be given a proportionately heavier representation in its composition. Instead of being a standing committee, it would be a “pool” of individuals (perhaps wider than at present) from which Panels of 5-6 would be drawn, either by lot or rotation, to handle individual cases. This would preserve the practitioner input to the decision-making process, while allowing Listing Committee members to devote more time to each case, since they would be called upon less frequently. To maintain consistency and continuity, the Chairman or Deputy Chairman of the Committee would participate in all Panels. Whether the Panels would be advisory or decision-making is open to discussion. The answer to this would influence the nature of the appeal mechanism. Either there would be a Listing Appeals Committee, as at present, or the ELB would act in this capacity.

7. **Advisory Committee:** The ELB would appoint an Advisory Committee to advise it on significant policy initiatives. This could include members of the Listing Committee and others (particularly investors). This should help to address some of the concerns expressed in the PIPSI Report about consultation procedures.

8. HKEx considers that this structure fully addresses the lack of clarity regarding the power and responsibility of the present Listing Committee. It would add weight to the listing regulatory function generally. It would preserve the market input to the decision-making process. It would create a framework which could help in the recruitment of

experienced executives. It would maintain and strengthen the “Chinese Wall” between the listing regulatory function and the revenue-generating units of HKEx. It should enable the SFC to feel comfortable in standing back to a greater extent and allowing the ELB to perform its functions. It would also clarify accountability, which would rest clearly with the ELB except in relation to statutory enforcement, where it would rest with the SFC (whose ability to act in this context would be strengthened if the suggestions in Section II below are implemented). The new structure suggested here should also make it easier for the SFC to exercise its monitoring and auditing role. And it would represent incremental change to the existing system, as opposed to radical reform which would be likely to create a new set of problems.

SECTION II

Legislative Changes

9. In our First Submission, we explained why, in the view of HKEx, the Listing Rules should not be made statutory and their administration should not be transferred to the SFC. We expressed the view that the main cause of current dissatisfaction with HK’s investor protection regime in some sectors of the public (particularly in relation to minority shareholders) is the paucity of relevant statutory requirements and enforcement mechanisms. We suggested this should be addressed by adding to primary legislation some carefully-chosen specific statutory provisions for the regulation of listed companies, together with improved rights of action for investors.

10. Although amendment of the law lies outside HKEx's field of responsibility, HKEx feels that it has a duty to express views about the law, given its role as front-line regulator of listed companies, and also because the debate about who should administer the Listing Rules has become entangled with that about the need for stronger enforcement tools to deal with abusive corporate conduct. The views we express below do not pretend to be comprehensive. Nor do we claim the depth of expertise in this field possessed by other bodies with an interest in these matters. We hope, however, that these views may assist the Expert Group to identify solutions to some of the real problems.
11. **Gap in Statutory Framework:** We made the point in our previous submission that HK's statutory regime for dealing with listed companies and corporate crime (including fraud and theft) has certain deficiencies. We remarked on the absence of a corporate regulator with the clear mandate and resources to enforce the provisions of the Companies Ordinance. We also noted the difficulty of trying to regulate through company law, given the preponderance of overseas-incorporated listed companies in HK. It is beyond HKEx's scope to say what should be done in relation to companies that do not seek a listing. As far as listed companies are concerned, the statutory regulator and enforcer should clearly be the SFC.
12. However, the scope of the statutory mandate of the SFC in relation to listed companies is ambiguous and less extensive than that possessed by comparable bodies in most other developed markets. The reasons for this lie partly in the fact that HK's legislative framework is derived largely from that of the UK. In the UK, statutory investor protection measures were historically contained in company law, which of course

relates mainly to the place of incorporation of the relevant company (although parts of company law can and do extend to overseas companies which have a sufficient “nexus” with the jurisdiction - which would normally include being listed there). In North America, for historical reasons, a body of securities law grew up in the first half of the last century, based not on the place of registration of the listed company, but on that of its listing and/or of the investors who buy its securities. Listed companies in North America are required to comply with a comprehensive statutory framework, in addition to the Listing Rules of the relevant exchange. The UK has, in the past 18 years or so, also developed a more comprehensive body of securities law and the institutions to enforce it. Other Commonwealth countries have addressed the same issues, although not always in the same manner. Hong Kong, even in the recent Securities and Futures Ordinance (“SFO”), has not travelled so far down this road.

13. **Basic Statutory Obligations:** The starting-point for most systems of securities law is statutory disclosure obligations for listed companies and their directors, enforced by a statutory regulator. At present, the key statutory requirement (the prospectus) is focussed on the primary market. There is limited statutory regulation of listed companies in the secondary market. The SFO addressed this indirectly via the “dual filing” mechanism. This is an important and helpful step. However, it stops short of widespread international practice, which generally includes a statutory requirement for all listed companies to prepare and publicly disclose at least the following:

- . Annual audited financial statements, prepared in accordance with recognised accounting and auditing standards within a prescribed number of days of the relevant financial year end;
- . A management discussion and analysis of the annual audited financial statements requiring management to address the reporting issuer's financial performance, and explain and discuss changes from the past financial year's performance;
- . Interim unaudited financial statements, prepared in accordance with acceptable standards within a prescribed number of days from the end of the relevant period;
- . A public notice immediately following any material change in the business and affairs of the listed company which:
 - (a) is necessary to enable the public to appraise the position of the issuer;
 - (b) is necessary to avoid the establishment of a false market in its securities;
 - (c) might reasonably be expected materially to affect market activity in, and the price of, its securities;to be followed by the filing of a material change report within a specific period, describing such change.

14. Statutory disclosure requirements would normally also mandate that transactions in which any director or connected person of a listed company has an interest should be fully disclosed to shareholders; where such transactions are significant, approval may be required from shareholders as a whole or from minority shareholders.

15. The above statutory disclosure requirements would continue to apply to a listed company even if it delists, unless the company is privatized in accordance with the Listing Rules and Takeovers Code. This would provide ongoing protection to shareholders of delisted companies.
16. In some markets (notably the USA) there are additional requirements – for example, those contained in the recent Sarbanes-Oxley Act (including certification of financial statements by specified officers, with attendant civil and criminal penalties).
17. **Related-Party Transactions:** In relation to protection of minority shareholders, the stronger statutory disclosure requirements described above would help. However, they do not deal fully with abuse through related-party transactions. It is around this subject that much of the public debate in HK is centred. At present, the main defence against such abuse is Chapter 14 of the Listing Rules. There are few statutory provisions which enable the regulators to intervene in such situations, or investors to bring actions against company controllers. Our previous submission mentioned sections 29A and 37A of the Securities and Futures Commission Ordinance (which permit the SFC to take action in cases of “unfair prejudice”), but these appear to have proved difficult to use.
18. HKEx believes the solution to the problem of minority abuse lies in a limited number of well-chosen additions or amendments to either the Companies Ordinance or the SFO (including those suggested above), of which the SFC should be the statutory enforcer. HKEx generally supports the proposals in the Consultation Paper of July 2001 from the

Standing Committee on Company Law Reform (“SCCLR”). These include the following new provisions to be added to the Companies Ordinance (“CO”):

- (a) A derivative right of action should be introduced allowing shareholders or directors (without leave of the court) to bring an action on behalf of the company for a wrong done to the company where the company is unwilling or unable to do so; the grounds for such action would include fraud, negligence, default in relation to any laws and breach of duty; this remedy would apply to companies listed in HK, whether registered here or not.

- (b) The “unfair prejudice” remedy under section 168A of the Companies Ordinance should be extended in various ways, including a power for the court to award damages and compensation of costs to shareholders, and to require controlling shareholders to buy out the minority shareholders; this remedy would also be extended to members of overseas companies listed in HK (unfair prejudice would, incidentally, include the payment of excessive remuneration to directors, diversion of assets, and the use of corporate assets to subsidise the business of related persons).

- (c) The SFC would be able without court approval to bring derivative actions against wrongdoers in relation to a listed company (including an overseas company) for breaches of duty, including fraud, negligence, default in relation to any laws and any other misconduct in relation to an investigation or the recovery of property.

- (d) Transactions in which any director or connected person of a HK-registered company has an interest should be disclosed to shareholders; where such transactions are significant, they should be submitted to disinterested shareholders for their approval.
- (e) Approval of disinterested shareholders in HK companies should be obtained in relation to transactions (including the acquisition or disposal of assets) above a specified size involving directors, or persons connected with directors, or potentially benefiting such persons.
- (f) Connected transactions involving controlling shareholders of HK companies must also be disclosed and subject to a disinterested shareholders' vote.

However, (d), (e) and (f) above would not (in the form proposed by SCCLR) extend to overseas companies, even if they are listed on HKEx.

19. As already mentioned, HKEx is reluctant without fuller consideration to make firm proposals concerning statutory provisions. There are other bodies whose responsibilities lie in this area. However, the following are some respects in which we believe measures going beyond those proposed by the SCCLR might be worth considering.
20. The first of these is statutory disclosure requirements along the lines described in paragraph 13 above. In particular, a statutory obligation to disclose material changes in the business (including any related-party aspect) should increase market transparency significantly. The “dual filing” rules in the SFO will catch deliberate false or misleading

disclosures, but they do not adequately address failures to disclose material information.

21. Second, a weakness of the proposed statutory requirements in relation to connected transactions (paragraph 18 (d), (e) and (f) above) is that they would apply only to HK-registered companies. HKEx believes consideration should be given to extending these requirements to all companies listed in HK. This would not, in HKEx's view, constitute "extra-territorial" legislation. The fact of being listed in HK should constitute a sufficient "nexus" with the SAR to justify such legislation.
22. Third, to make it more practical for shareholders to pursue derivative actions and the unfair prejudice remedy (paragraph 18 (a) and (b) above), consideration might be given to the creation of a fund, administered by the SFC, which could be used (where the SFC judges this to be in the public interest) to assist in the funding of such cases.

SECTION III

HKEx's Business Development Role

23. In its First Submission, HKEx made the point that the listing function is important to HKEx strategically. HKEx faces increasing competition from exchanges in other international financial centres, particularly for China listings. Nasdaq has established an office in Shanghai. The New York Stock Exchange pays increasingly frequent visits to China. The Singapore Stock Exchange has listed 19 Mainland companies and also has an office there; it is targeting particularly China's private sector companies. The London Stock Exchange is building up its business

development team for China, as head of which it recently hired a Mainland-born executive. Other exchanges which are marketing their services in China include Australian Stock Exchange, Tokyo Stock Exchange, Korea Stock Exchange, Kuala Lumpur Stock Exchange, Deutsche Borse AG, Borsa Italiana and Toronto Stock Exchange.

24. So far, HKEx has held its ground against this competition. Partly as a result of HK having led the way in developing the “H” share market, we have become the natural “home market” for “international” listings of mainland companies. Secondary market activity tends to gravitate towards HK also because we have an investor base which knows about, and is interested in, China. But this position cannot be taken for granted. Once a critical mass of listings is established in another financial centre, liquidity can quickly flow that way.

25. In this competitive struggle, one of HKEx’s distinguishing features is that it controls the listing function. HKEx is able to represent itself as a “one stop shop” for Mainland enterprises. The fact that it controls its own product permits this to be adapted relatively quickly to meet the needs of the market. It is doubtful that a government agency could be equally flexible and responsive. It is also highly doubtful that a statutory regulator could be equally effective in selling the product, both because it does not control the delivery platform and because business development is not its natural role. Nor would Mainland enterprises (particularly from the private sector) be likely to feel as comfortable dealing with a government agency as with a private sector exchange.

26. In developing a market, there has to be a balance between enterprise and control. HKEx believes it has struck that balance successfully in

relation to the Mainland. HKEx is concerned that fragmenting the product would tilt the balance too far towards control. A few companies might be kept out which turn out to be money-losers. In the process, a larger number of companies which become successful would be likely to get turned away to other markets, to the detriment of HK.

Conclusion

27. HKEx hopes that the above ideas address the main issues being considered by the Expert Group. HKEx would be happy to submit further comments on any aspect of the Group's work, and would welcome further opportunities to meet with the Group to discuss its submissions. In relation to the proposed adjustments to institutional arrangements (paras 3-8 above), HKEx is aware that there are a number of aspects of the model which need to be elaborated upon in more detail in consultation with interested parties. HKEx would be very happy to discuss these with the Expert Group and (if appropriate) with Government. Our hope is that the Expert Group will give HKEx sufficient encouragement to pursue the proposals outlined here.